

STATEMENT OF REASONS
FOR CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the Commissioner of Corporations ("Commissioner") sets forth below the reasons for the proposed amendment to Sections 260.210, 260.211, 260.211.1, 260.234, and 260.241 of the California Code of Regulations (10 C.C.R. Sec. 260.210, 260.211 260.211.1, 260.234 and 260.241).

The Corporate Securities Law of 1968 ("CSL") requires any broker-dealer who conducts business in this state to obtain a certificate from the Commissioner, unless that broker-dealer is exempt from the licensing requirements.

On June 1, 1998, California was reclassified by Central Registration Depository ("CRD")/National Association of Securities Dealers Regulation ("NASDR") as an "automatic" state, which means that agents that do not have disciplinary histories can be automatically allowed to be employed by a broker-dealer in this state. Agents with disciplinary histories of the type specified in Corporations Code Section 25212 will continue to have their disciplinary histories reviewed by the Department of Corporations ("Department"). In light of California becoming an automatic state, the Commissioner has reviewed current rules proposes to amend Section 260.210.

Section 260.210. This section sets forth agent procedures for licensed broker-dealers pursuant to Section 25211 of the Corporations Code. The Commissioner proposes to amend Section 260.210(b)(1) to link the review of an agent's disciplinary history by the Department under the CSL with the command instructions of the CRD system.

Under the CSL, the Department does not approve applications for registration or license agents. As an "automatic" state, the Department only reviews the employment histories of individual agents with disciplinary histories for acts prohibited by Section 25212 of the Corporations Code. Upon reviewing the disciplinary history of an individual agent, the Department then notifies the prospective employer of the individual's disciplinary history. Under Section 25213 of the Corporations Code, the Commissioner may issue an order to deny or bar employment of an agent with a prohibited disciplinary history, but will not approve or disapprove employment. It is the prospective employer who decides to employ or not employ the agent based on the agent's disciplinary history. Also, Section 260.210(b)(1) allows the Department to "abandon" a CRD application if additional information is not received; however, the CRD system only has the command instructions "approve" or "reject". These changes are necessary to link the Department's review of an agent's disciplinary history with the command instructions of the CRD system.

The Commissioner proposes to adopt new subparagraph (b)(2) of Section 260.210 to allow the temporary transfer of the CRD registration of an agent from one broker-dealer to another through the Relicensing program ("Relicensing program") of the North American Securities Administrators Association ("NASAA"). This amendment is consistent with the policy

of the NASDR, will facilitate the transfer of eligible agents within California and alleviate unreasonable delays and burdens on these agents and broker-dealers.

In 1984, the National Association of Securities Dealers, Inc., (“NASD”) (now known as the National Association of Securities Dealers Regulation or “NASDR”) endorsed the North American Securities Administrators Association’s Temporary Agent Transfer (“TAT”) program. This program replaced NASD’s conditional approval process and permits the immediate but temporary transfer of an agent from one broker-dealer to another broker-dealer upon notification through the CRD.

The TAT program was developed in response to the securities industry concerns regarding delays in CRD registration of the transfer of the employment of agents between one broker-dealer to another. Although registrations and terminations through the CRD have reduced overall processing times, other factors (i.e., U.S. Mail) and the failure of timely submission by the terminating broker-dealer firm may slow down the agent transfer process.

The TAT program requires that the request to transfer employment be made no later than seven calendar days after the agent has terminated employment and registration with the terminating broker-dealer where the agent does not have a disciplinary history. The temporary registration period expires 21 days after the date of issuance, unless the CRD registration is made permanent by the filing of a properly completed and executed Form U-4. In addition, both the agent and the broker-dealer must be currently registered with the NASDR in each jurisdiction where the temporary transfer of registration is being requested, and the broker-dealer must have sufficient funds on deposit with the CRD to pay the required CRD registration fees.

Recently, the NASDR, in conjunction with the NASAA, have re-engineered the prior CRD system using, state-of-the-art, Web-based technologies. This modernized Internet-based CRD system (“Web CRD”) debuted in August 1999. The goals of Web CRD are to speed-up the CRD registration or notification process while continuing to protect investors from unscrupulous agents and broker-dealers, and provide regulators with the ability to monitor and track agents and broker-dealer firms with disciplinary histories. As part of the Web CRD, the Relicensing program replaces the TAT Program.

The Relicensing program will allow for the automatic CRD registration of agents who have no reportable disclosure items and as well as certain agents with previously reported disclosures items, but who have no new reportable disclosure items since the last review or approval. An agent may only participate in the Relicensing program if he or she was registered in that jurisdiction within the preceding 30 days, and requests participation in the Relicensing program. A request for participation in the Relicensing program is made by completing and submitting to the agent’s employing broker-dealer the Relicensing Section of the Uniform Form U-4.

With the exception of California, all other states participate in the TAT Program and upon implementation of the Web CRD all states, including California, will automatically participate in the Relicensing program.

In order for an agent to transfer from one broker-dealer to another, the terminating broker-dealer must file the Form U-5 with the NASDR. Once the Form U-5 is properly filed and approved, the employing broker-dealer must file a Form U-4 with the NASDR. In the interim, an agent may not conduct any business in this state. This unnecessarily penalizes agents that have no disciplinary history.

To facilitate the expeditious transfer of eligible agents within California and alleviate delays, the Commissioner has determined it is necessary to adopt new subparagraph (b)(2) of Section 260.210 to allow the temporary transfer of agents through the Web CRD and to renumber subsequent subparagraphs.

Section 260.211 sets forth the procedures for applying for a certificate as a broker-dealer. Subsection (a) requires the applicant to use the Uniform Application for Broker-Dealer Registration (Form BD), and subsection (b) sets forth the Instructions for California.

The Commissioner proposes to amend subsection (b) to clarify, update or eliminate various requirements contained in subsection (b) of Section 260.211 (Instructions for California).

Part II. Instructions as to Arrest Records. The California Business and Professions Code Section 461 prohibits public agencies from requesting, on an initial application, that an applicant reveal a record of arrest that did not result in a conviction or plea of nolo contendere. In order to comply with Business and Professions Code Section 461, first-time broker-dealer applicants are instructed to amend specific questions contained in Uniform Application for Broker-Dealer Registration (Form BD) regarding arrest records. Currently, the question number and the manner in which the question is to be modified are set forth in this instruction.

In February 1998, the NASDR revised Form BD to, among other things, renumber and revise the questions regarding arrest records (Items 7F and 7G). In August 1999, as part of the rollout of Web CRD, Form BD was again amended and Items 7F and 7G were renumbered Items 11H(2) and 11G. The special instruction sheet will provide specific information on the questions in Form BD to be modified in accordance with Business and Professions Code Section 461. The special instruction sheet will also contain other information to assist an applicant in completing the Form BD. The special instruction sheet is available from any of the Department's offices and through the Department's internet home page. A copy of the special instruction sheet is attached as Exhibit 1.

The Commissioner believes that this amendment presents an efficient and economical solution to rulemaking. The other alternative, to amend this instruction each time the questions in Form BD relating to arrest records are changed, is unnecessarily time-consuming, costly and burdensome to the Department and reviewing agencies.

Part III. Additional Information. Item 2 - Organization Information. This item is being amended to require broker-dealers who file as limited liability companies ("LLC"), to include organizational document specific to LLCs. This addition is necessary because many broker-

dealer applicants are filing as LLCs and the organizational documents differ from those of a corporation or a partnership.

Part III. Item 3. Other Exhibits. The requirement in Item 3, that the applicant provide the name of its worker's compensation insurance or attach a copy of the certificate of consent to self-insure in Item (B) of Other Exhibits is being deleted. As far as the Department is concerned, this information is unnecessary. Simply asking the question does not verify or validate compliance. Determining compliance with the requirements of Labor Code Section 3700 is under the Department of Industrial Relations' jurisdiction.

Part IV. Investment Adviser Activities. This Part is being amended to clarify that the exemption in Section 25205 of the Corporations Code is not available to a broker-dealer registered with the Securities and Exchange Commission as an investment adviser. These broker-dealers should make a notice filing as required by Section 25230.1(b). AB 721 (Chapter 391, Statutes of 1997) amended the Corporate Securities Law of 1968 to conform provisions of the California securities law to the federal National Securities Markets Improvement Act of 1996 ("NSMIA"). One of the provisions of NSMIA provided the Securities and Exchange Commission ("SEC") with exclusive authority for the registration of investment advisers with \$25 million or more in assets under management and advisers to investment companies registered by SEC. As these broker-dealers no longer fall under California jurisdiction, the exemption provided by Corporations Code Section 25205 is no longer appropriate for them.

Currently, broker-dealers who rely on the exemption in Section 25205, are required to submit a copy of Part II of their Uniform Application for Investment Adviser Registration (Form ADV). The Commissioner proposes to require these broker-dealers to submit a complete copy of the Form ADV, a list of investment adviser representatives or associate persons, and the applicable reporting fee. The list must be on company letterhead and include the investment adviser representative or associated person's complete name, CRD or social security number, and business address. In addition, the list shall contain a statement affirming that all investment adviser representatives and associated persons included on the list meet the qualification requirements as set forth under Section 260.236, Title 10, California Code of Regulations. An officer of the investment adviser must sign this list under penalty of perjury.

The list is necessary to confirm that the investment adviser representatives or associated persons employed by the broker-dealer have satisfied the qualification requirements and also facilitates the reporting requirement under Corporations Code Sections 25608(p) and 25230(b). Corporations Code Section 25230(b) prohibits any person from conducting business as an investment adviser or conducting business on behalf of an investment adviser, unless that person has satisfied the qualification requirements of Section 260.236, Title 10, California Code of Regulations.

These requirements are patterned after the notice requirement of Corporations Code Section 25230.1(b) and are necessary for review purposes, public disclosure and to facilitate the reporting of investment advisers or associated persons required by Corporations Code Sections 25608(p) and 25230(b).

The notice is required to be filed with the Department by each SEC-registered investment adviser that conducts business in California consists of: a copy of the Order Granting Registration under the Investment Adviser Act of 1940; a Consent to Service of Process or Form U-2; a complete copy of Form ADV filed with the SEC; a notice filing fee; and Schedule D of Form ADV for each investment adviser representative or associated person with a place of business in California. In lieu of filing the Schedule D, an investment adviser who is dually certificated as a broker-dealer under Corporations Code Section 25210, that is a member of a self-regulatory organization and whose agents are dually affiliated as investment adviser representative or associated person may file a list identifying those investment adviser representatives that have a place of business in California. This list must be on company letterhead and include the investment adviser representatives' complete names, CRD numbers, places of business (mailing address, city and zip code) and an affirmative statement that all investment adviser representatives included on that list meet the qualification requirements set forth under 10 CCR Section 260.236. An officer of the Adviser must sign this list under the penalty of perjury.

Part IV is further amended to clarify that social security account numbers would not become part of public records. This change is necessary to reflect the Department's current practice of not disclosing an individual's social security number when complying with a request pursuant to the Public Records Act.

Section 260.211.1 sets forth the procedures and application for licensing by notification for broker-dealers who are exempt from licensing by Corporations Code Section 25211(b). The Commissioner proposes making similar changes as those proposed for Section 260.211, Part IV., to Section 260.211.1. Subsection (a) and subsection (b), Item 9 of the application by notification, are being amended to require a broker-dealer, who engages in business as an investment adviser in this state, but is not licensed as an investment adviser, to submit with the application by notification, a complete copy of the Form ADV and a list of investment adviser representatives or associated persons and the applicable reporting fee. The necessity for these changes are discussed above, in Section 260.211.

The Commissioner proposes additional amendments to the application for licensing by notification in subsection (b). Item 6.b. requires a broker-dealer to attach certain copies of the Form BD. Item 6.b. is being deleted for the following reasons: the pages and scheduled listed in Item 6.b. no longer correspond to the recently amended Form BD, and the NASDR is now requiring all broker-dealers, by December 31, 1999, to refile their Form BD's electronically. The complete Form BD will soon be available through WebCRD, eliminating the need copies to be attached to the application.

New Item 6.b. is former Item 6.b.C. In its current position at the end of the disclosure regarding social security numbers, the requirement to attach a completed Customer Authorization of Disclosure of Financial Records, is out of place. This is merely a formatting change.

The disclosure regarding social security numbers is being amended to clarify that social security account numbers would not become part of public records. This change is necessary to reflect the Department's current practice of not disclosing an individual's social security number when complying with a request pursuant to the Public Records Act.

Section 260.234 provides an exception from the prohibition on an investment adviser's compensation based on capital appreciation of clients' assets and references subsection (b), (c), (d) and (e) of SEC Rule 205-3. The Commissioner proposes to amend Rule 260.234 to conform it to recent changes and adopt the disclosure requirements which are similar to those disclosure requirements which were eliminated.

On August 20, 1998, the Securities and Exchange Commission amended Rule 205-3 (17 CFR 275.205-3) to provide investment advisers registered under the Investment Advisers Act of 1940, greater flexibility in structuring performance fee arrangements with clients that are financially sophisticated. New Rule 205-3 permits investment advisers to charge qualified purchasers or qualified clients and certain knowledgeable investment adviser employees performance or incentive fees. The amendments also modified the criteria for client eligibility to enter into a contract under which performance fees can be charged and eliminates provisions that specify required contract terms and disclosures (former subsections (b) through (e)).

In addition to the conforming changes being proposed, the Commissioner proposes to adopt subsection (a)(3) to require full disclosure of all material information regarding the proposed compensation arrangement prior to entering into a contract. The SEC has indicated that the elimination of the contractual and disclosure provisions (former subparagraph (d)) from SEC Rule 205-3 does not alter the obligation of an investment adviser, as a fiduciary, to deal fairly with its clients and to make full and fair disclosure of its compensation arrangements. This obligation includes full client disclosure of all material information regarding a proposed performance fee arrangement as well as any material conflicts posed by the arrangement. (See SEC Release No. IA-1731 at <http://www.sec.gov/rules/final/ia-1731.htm>.) Subsection (a)(3) does not impose any new standards and merely clarifies existing fiduciary duties of investment advisers.

Section 260.241 sets forth the books and records to be maintained by a broker-dealer. Subsection (a) is being amended to clarify that the Commissioner or the Commissioner's designee has access to and may make copies of any of the books and records maintained by the broker-dealer. This change clarifies the Commissioner's authority contained in Corporations Code Section 25241 to examine the books and records of a broker-dealer. References to Pacific Stock Exchange are changed to Pacific Exchange, as that is the current name of the exchange.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for, which the regulation is proposed, would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small businesses.

FISCAL IMPACT

Cost to Local Agencies and School Districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None. No other nondiscretionary cost or savings are imposed on local agencies.

DETERMINATIONS

The Commissioner has determined that the proposed regulatory action does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.